Decision 02-10-046 October 24, 2002

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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| Application of Pacific Gas and Electric Company (U 39 E) for an Order Approving the Settlement Agreement Between PG&E, Sierra Pacific Industries and the California Independent System Operator. | Application 02-08-005 (Filed August 6, 2002) |

# ORDER APPROVING SETTLEMENT AGREEMENT

The Commission approves the Settlement Agreement between Pacific Gas and Electric (PG&E), Sierra Pacific Industries (SPI), and the California Independent System Operator (ISO). The Settlement Agreement resolves SPI's state court lawsuit against PG&E and the ISO, resolves SPI's bankruptcy claim against PG&E, and reinstates (with modification) four power purchase contracts between PG&E and SPI.

## The Litigation

SPI operates four biomass-fueled cogeneration facilities located at lumber mills in Burney, Lincoln, Quincy, and Susanville. SPI had 30-year Interim Standard Offer 4 power purchase agreements with PG&E for these facilities dating from the mid-1980s. In 2001, as a result of the energy crisis, PG&E only partially paid SPI for power that SPI delivered under the power purchase agreements.

In March of 2001, SPI asserted that it had the contractual right to terminate the power purchase agreements as a result of PG&E's non-payment. PG&E

disputed SPI's right to terminate the agreements, and the ISO would not allow SPI to change its scheduling coordinator from PG&E without PG&E's consent. On April 2, 2001, SPI filed a lawsuit against PG&E and the ISO. SPI alleged that PG&E breached the power purchase agreements, that SPI could terminate the power purchase agreements, and that PG&E owed SPI $18 million for energy and capacity deliveries during the months of December 2000 through March 2001. SPI also alleged tort, unfair business practice and antitrust causes of action against PG&E and the ISO for refusing to switch SPI's scheduling coordinator. In addition to payment for the energy and capacity it delivered to PG&E, SPI sought approximately $89 million for its future lost profits for the remaining 15 years of the power purchase agreements, and treble and punitive damages. SPI's claims added up to over $1 billion.

On April 4, 2001 SPI moved for a temporary restraining order (TRO) to allow it to sell power into the wholesale market. Over PG&E's opposition, the court on April 5, 2001 granted SPI's motion for a TRO, and allowed SPI to switch scheduling coordinators and start selling into the wholesale market. SPI began doing so on April 7, 2001.

PG&E filed for bankruptcy on April 6, 2001, and subsequently removed SPI's lawsuit to federal Bankruptcy Court. On May 26, 2001, Judge Montali of the Bankruptcy Court granted SPI's request for a preliminary injunction allowing it to continue selling into the wholesale market.

On July 10, 2001, SPI filed a motion for partial summary judgment on a cause of action for declaratory relief. Over PG&E's opposition, Judge Montali granted SPI's motion on October 6, 2001, holding that PG&E's partial payments constituted a material breach of the power purchase agreements, giving SPI the right to terminate those agreements. In addition, Judge Montali found that

PG&E was not entitled to obtain payments from SPI under the early termination or "minimum damages" provision of the power purchase agreements.

In November 2001, SPI, over PG&E's opposition, successfully moved to remand its suit to state court. Since that date the parties have engaged in significant discovery and motion practice.

In April 2002, the parties agreed to mediation.[1] Mediation began on June 4, 2002, followed by negotiations resulting in the parties' executing a master settlement agreement on July 22, 2002.

## At the Commission

PG&E filed its Application[2] on August 6, 2002, requesting Commission approval of the Settlement Agreement it had negotiated with SPI and the ISO. The Application requested highly expedited review by the Commission, and specifically requested that the Settlement Agreement be approved by October 4, 2002.

No Protests were filed in response to the Application. At the Prehearing Conference (PHC), held on September 13, 2002, PG&E, SPI and the ISO stated their support for the Settlement Agreement. Staff for the Commission's Office of Ratepayer Advocates (ORA) entered an appearance at the PHC and, while not squarely opposing expedited Commission approval of the Settlement Agreement, did express a concern about rate recovery for one aspect of the Settlement Agreement. All parties agreed that evidentiary hearings were not necessary.[3]

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[1] The mediator was Layn R. Phillips, a retired federal district court judge.

[2] Application of PG&E for an Order Approving the Settlement Agreement Between PG&E, Sierra Pacific Industries, and the California ISO.

[3] Subsequently, the parties stipulated to waive comments on the Draft Decision, consistent with Pub. Util. Code § 311.

The Settlement Agreement requires the approval of both the Commission and the Bankruptcy Court. The Bankruptcy Court approved the Settlement Agreement on September 12, 2002.[4] The substantive terms of the Settlement Agreement are: 1) PG&E pays SPI $17,950,371.15 owed for power delivered from December 2000 through April 7, 2001, paid in monthly installments to be completed by June 4, 2003 and including 5% interest, compounded monthly; 2) SPI pays PG&E $912,050 owed PG&E for energy offsets, on identical terms; and 3) The power purchase agreements will be reinstated with modifications. For four years after reinstatement, SPI will receive 5.37¢ per kilowatt hour (kWh) for energy deliveries, after which SPI will receive short-run avoided cost (SRAC) for the remainder of the contractual term.[5] In addition, SPI will be allowed to "pool" the energy from its four plants.

## ORA's Position

ORA argues that PG&E has not adequately shown that any liability that might ultimately result from the litigation would necessarily be recoverable in rates, and absent such a showing it is unreasonable for PG&E to be granted rate recovery for the costs of the settlement.

[4] PG&E provided a copy of the Order of the Bankruptcy Court at the PHC.

[5] The source of the 5.37¢ rate is Decision (D.) 01-06-015. In that Decision, we sought to bring stability to utility / QF contracts, and to ensure that Qualifying Facilities (QFs) generated as much electricity as possible at reasonable prices. To provide an incentive to maximize QF production, we pre-approved three types of contract modifications, one of which replaced the SRAC formula with a fixed price of 5.37¢ for five years. Since SPI no longer had a contract with PG&E at that time, it could not avail itself of this contract modification.

Specifically, ORA objects to ratepayers paying for power from SPI at the rate of 5.37¢ per kWh for four years.[6] According to ORA, SPI would only be entitled to payment under its contracts at SRAC, which is currently below 5.37¢ per kWh. ORA, citing PG&E figures, values the increment between the 5.37¢ rate and the SRAC-based rate at a net present value of $7.95 million for the four year period. The rate recovery of this $7.95 million increment is what ORA is questioning.

ORA further notes that the Settlement Agreement allows PG&E to waive the requirement that the Commission provide for full rate recovery. ORA recommended that the Commission separate out the question of rate recovery from approval of the Settlement Agreement, so that the Commission could approve the Settlement Agreement in an expedited manner, but examine the rate recovery issues presented by ORA in more detail and on a more deliberate schedule.

## PG&E's and SPI's Positions

PG&E disagrees with ORA. PG&E asserts that any liability it incurs as a result of the litigation at issue would likely be recoverable from ratepayers. Furthermore, PG&E argues that approval of the present Settlement Agreement is consistent with both Commission policies and recent precedents. PG&E cites to the Commission's recent approval of a similar settlement in the *Oildale* proceeding (D.02-08-068). PG&E argues that the record in this proceeding regarding litigation risks is much more extensive than the record in the *Oildale*

[6] ORA has not challenged or questioned the payment by PG&E for power delivered, nor has ORA challenged or questioned the reinstatement of the contracts (at SRAC rates) for the period beyond the four years.

proceeding, and accordingly there is a stronger case for Commission approval here than was presented in the *Oildale* proceeding.[7]

PG&E also stated that it was not willing to waive the requirement of rate recovery contained in the Settlement Agreement, given the large dollar amount potentially put at risk by ORA's proposal.

SPI also has a different perspective than ORA. In SPI's view, PG&E's breach of contract resulted in SPI being deprived of five years at a rate of 5.37¢ to which it would otherwise have been entitled, which SPI estimates to be worth approximately $10 million. Accordingly, the four years at 5.37¢ contained in the Settlement Agreement (valued at roughly $8 million) means that SPI is giving up approximately $2 million. If the case were to be litigated, SPI states that it would seek the full $10 million.[8]

In addition, SPI claims that failure to approve the Settlement Agreement in a timely manner could result in adverse business consequences both for the QFs and for the lumber mills that provide their fuel.

## Analysis

The central question we are faced with is whether the litigation risk faced by ratepayers justifies the cost to ratepayers of the Settlement Agreement.[9] According to ORA, and undisputed by PG&E and SPI, that cost is the roughly $8 million described above. There is no dispute among the parties that PG&E

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[7] PG&E also acknowledged the existence of the somewhat similar *Gaylord* proceeding (A.02-01-041), but at the time of the PHC, there had been no Commission decision in that proceeding. The Commission subsequently denied PG&E's application in D.02-09-047, voted out on September 19, 2002.

[8] We do not assume that SPI would limit its claims in litigation to $10 million.

[9] Other policy concerns do color our analysis, such as our stated concerns about market stability, the continued viability of QFs generally, and QFs' contributions to the electric grid. (See *Oildale* and *Gaylord*, supra.)

should pay for past power deliveries by SPI, nor is there a dispute about SPI receiving SRAC rates after the expiration of the four year period identified in the Settlement Agreement.

Accordingly, we must focus upon the $8 million cost to ratepayers, and, for purposes of our analysis, assume that the Settlement Agreement is absent and that litigation would continue. In that context we will attempt to determine what the odds would be of the ratepayers being required to pay more than $8 million, (and how much more).

Evaluating litigation risk is at best an imprecise art, but it remains the primary way for us to judge whether the Settlement Agreement is reasonable for the ratepayers of PG&E. The tools available for our use in evaluating the reasonableness of the Settlement Agreement are the known facts about the litigation between PG&E and SPI, and the Commission's recent decisions in the *Oildale* (D.02-08-068) and *Gaylord* (D.02-09-047) cases.

One of the most compelling factors in favor of approving the Settlement Agreement is that PG&E appears to be losing in court. SPI has obtained partial summary judgment against PG&E, including a specific finding that PG&E materially breached its power purchase agreements with SPI. This indicates that there is a substantial litigation risk to PG&E. The determination of breach of contract has already been made (subject to appeal), with the issue of damages still remaining.

We know that SPI would be seeking at least $10 million, and probably more, given its claim for $89 million in future lost profits for the remaining 15 years of the power purchase agreements. PG&E could seek offsets or other mitigation of damages, but we note that PG&E has failed in its effort to litigate one possible offset against SPI: the early termination or "minimum damages" provision of the power purchase agreements. In addition, the source of the problem that ORA is complaining about, that 5.37¢ per kWh is above market rates, results in the conclusion that SPI, by selling its power elsewhere, is unlikely to significantly mitigate its damages. While SPI may not obtain $89 million, given the current status of the litigation, SPI appears to have a good chance of obtaining more than the $8 million at issue from PG&E on its breach of contract claims.

SPI has also alleged tort, unfair business practice, and antitrust claims against PG&E and the ISO, resulting in a total claim of $1.1 billion. PG&E states that it accorded these claims little weight during settlement negotiations. We believe that PG&E was correct in this assumption. Nevertheless, should SPI have even limited success on just a portion of these claims, the damages could easily exceed $8 million.

Looking only at PG&E's possible liability, however, is not enough. ORA has correctly pointed out that the proper analysis focuses upon ratepayer liability, since PG&E is asking ratepayers to pay the cost of the Settlement Agreement. This analysis confirms that our primary focus should be on the breach of contract claims, rather than the tort, unfair business practice and antitrust claims. As a general rule, utility expenses for the former (if reasonable) are recoverable in rates, while expenses for the latter are not. (See, e.g. D.00-02-046, Section 9.2.2.7.3.) Accordingly, for purposes of evaluating the Settlement Agreement, we will assume that ratepayers would most likely be required to pay for PG&E's potential liability for breach of contract, but would not be required to pay for PG&E's potential liability on SPI's other claims. Even with this limitation on ratepayer exposure, the likelihood of ratepayer liability in excess of $8 million is sufficient (for the reasons discussed above) to support our approval of the Settlement Agreement.

We would note that rate recovery for breach of contract costs is typically done on a forecast basis in a general rate case, and based upon an average of historical costs. (Id.) That approach is different from what PG&E is requesting here. In this case, PG&E is asking for a case-specific determination of rate recovery for actual costs. In the recent *Oildale* case (*supra*), however, we approved the same rate recovery approach sought here by PG&E. The present case and the *Oildale* case represent collateral damage of the energy crisis, and accordingly the unique treatment of rate recovery for breach of contract followed here should not be construed to work a change on the Commission's more general practices. We also do not want ratepayers to possibly pay twice for the same liability, so we will order that no part of the Settlement Agreement approved here should be used in calculating future forecasts of breach of contract (or other litigation) expenses.

Our Decision today is consistent with our two most recent precedents on this issue. In *Oildale*, we approved a settlement whose structure is very similar to that we approve today. PG&E is correct that the record here is much stronger than in *Oildale* in providing a basis for the Commission to approve a settlement. Here we have a case where PG&E's liability for breach of contract has been established as a matter of law, leaving only the determination of damages.[10] No such determination had occurred in *Oildale*, and our Decision in that case (including a dissent by Commissioner Wood) reflects the difficulty of evaluating litigation risks at an earlier stage of litigation.

In *Gaylord*, PG&E asked the Commission to approve another settlement with a structure similar to that presented both here and in *Oildale*, with ratepayers being asked to pay a premium price (again 5.37¢ per kWh) for energy

[10] The non-contract claims also remain to be litigated.

from Gaylord's QF for a period of 3 ½ years. However, we determined that the approval of this rate was not directly related to the potential costs of the litigation between PG&E and Gaylord. In other words, PG&E failed to show that ratepayers bore any risk of litigation, and accordingly it was unreasonable for ratepayers to pay to eliminate a non-existent risk. As compared to the *Gaylord* case, litigation of the present case does bear potential risk to ratepayers.

The Commission's Rules of Practice and Procedure require that any stipulation or settlement, in order to by approved by the Commission, must be reasonable in light of the whole record, consistent with the law, and in the public interest. (Rule 51.1(e).) In evaluating settlements in the context of utility / QF litigation, the Commission has identified a number of factors that it will review, and has specifically stated:

> These factors include whether the settlement reflects the relative risks and costs of litigation; whether it fairly and reasonably resolves the disputed issues and conserves public and private resources; and whether the agreed-upon terms fall clearly within the range of possible outcomes had the parties fully litigated the dispute. The Commission also has considered factors such as whether the settlement negotiations were at arm's length and without collusion, whether the parties were adequately represented, and how far the proceedings had progressed when the parties settled…
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> Moreover, we have held in the context of evaluating utility-QF settlements that the mere existence of a dispute or a "colorable claim" regarding a contract does not ensure that any settlement of that contract is reasonable. The "colorable claim" must raise "substantive issues of law and fact." (D.00-11-041, *mimeo.*, pp.6-7, citations omitted.)

As described above, the settlement appears to reflect the relative risks and costs of litigation, and its terms fall clearly within the range of outcomes had the parties fully litigated the dispute. Clearly the settlement conserves both public and private resources, as it would reduce litigation costs for the parties, as well as the burden on the court system of a vigorously litigated and complex case.

While the parties are currently aligned in their request for Commission approval of the settlement, the negotiations appear to have been at arm's length, given the significant litigation that preceded the negotiations. All parties are sophisticated business entities, and all were represented by experienced counsel.

The litigation has progressed beyond the summary judgment stage, providing a clear record that there are in fact substantive issues of law and fact, present, and showing that the dispute is significantly more than just a "colorable claim."

We find that the Settlement Agreement is reasonable in light of the whole record, consistent with law and in the public interest. The record in this case consists of the application and supporting testimony submitted by PG&E (including an errata dated September 6, 2002), the transcript of the PHC, and our official notice of the Order of the Bankruptcy Court. The record lays out in detail the history and nature of the litigation, the contents of the Settlement Agreement, ORA's concerns, and PG&E's and SPI's responses to those concerns.

The Settlement Agreement is consistent with the law. The Commission has approved similar settlements in the past. ORA has not contended that the Settlement Agreement is in any way illegal, but only that the ratemaking treatment it calls for should be bifurcated (for further examination) from the expedited approval of the Settlement Agreement's more general terms, which ORA does not oppose.

The question of whether the Settlement Agreement is in the public interest is the most difficult of the three to determine. However, based on our above analysis of the litigation risk, and our review of the factors involved in evaluating litigation of this type, we have concluded that the Settlement

Agreement is in the public interest. Accordingly, we approve the Settlement Agreement.

## Waiver of Comment Period

Pursuant Section 311(g) and Rule 77.7(g) of the Commission's Rules of Practice and Procedure, the otherwise applicable 30-day period for public review and comment is being waived because the parties have stipulated to waive the 30-day comment period.

## Assignment of Proceeding

Carl Wood is the Assigned Commissioner and Peter Allen is the assigned Administrative Law Judge in this proceeding.

## Findings of Fact

1. PG&E has been engaged in litigation in civil and bankruptcy court with SPI, as described above.

2. SPI prevailed in obtaining a temporary restraining order, a preliminary injunction, and partial summary judgment against PG&E on its claim of breach of contract.

3. SPI is seeking at least $10 million and up to $89 million in damages from PG&E for breach of contract.

4. PG&E was unsuccessful in its efforts to obtain damages from SPI under the minimum damages provision of the power purchase agreements.

5. The incremental cost to ratepayers of the Settlement Agreement is approximately $7.95 million.

6. PG&E has a reasonable likelihood of recovering in rates any damages it may have to pay SPI for breach of contract.

7. The parties to the litigation are sophisticated business entities, all of whom were represented by experienced counsel.

8. The litigation between the parties was active and contentious, and the Settlement Agreement was negotiated at arm's length.

9. Continuation of the litigation would result in significant additional litigation costs for all parties.

10. All parties stipulated to waive comments on the Draft Decision.

## Conclusions of Law

1. There is a reasonable likelihood that ratepayer liability as a result of litigation would be higher than the ratepayer liability of the Settlement Agreement.

2. The Settlement Agreement is reasonable in light of the whole record.

3. The Settlement Agreement is consistent with the law

4. Approval of the Settlement Agreement is in the public interest.

5. The Settlement Agreement should be approved.

6. Ratepayers should not have to pay twice for the cost of the Settlement Agreement.

7. This proceeding should be recategorized as ratemaking without hearings.

## O R D E R

**IT IS ORDERED** that:

1. This proceeding is recategorized as ratemaking without hearings.

2. The Settlement Agreement between Pacific Gas and Electric Company, Sierra Pacific Industries, and the California Independent System Operator is approved.

3. The Settlement Agreement shall not be used in calculating future forecasts of breach of contract expenses or other litigation expenses.

4. This proceeding is closed.

This order is effective today.

Dated October 24, 2002, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners